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Administrative Law—Internal Revenue Code—Proof Required To Open a "Closed Year."—United States v. Powell

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Administrative Law—Internal Revenue Code—Proof Required to Open a "Closed Year."—*United States v. Powell*.¹—In March 1963, the Internal Revenue Service, pursuant to Section 7602(2) of the Internal Revenue Code, summoned Powell to appear before an agent to give testimony and produce records relating to 1958 and 1959 returns of the William Penn Laundry (taxpayer), of which Powell was president. The asserted basis for the summons was fraud. Powell refused to produce the records. Because taxpayer's returns had been once previously examined and because the statute of limitations barred assessment of additional deficiencies for the years in question except for fraud, Powell contended that before he could be forced to produce the records the Service would have to indicate some grounds for its belief that fraud had been committed. The agent declined to give such information. Thereafter, the Service petitioned the District Court for the Eastern District of Pennsylvania for enforcement of its administrative summons. An affidavit was filed alleging (1) that the Service had been investigating taxpayer's returns, (2) that the Regional Commissioner had determined that an additional examination was necessary and had sent Powell a letter so stating, and (3) that the Service had reason to suspect that the taxpayer had fraudulently falsified the returns. The district court granted the agent an hour to re-examine taxpayer's records. The court of appeals reversed.² It concluded that the affidavit in itself was not sufficient to satisfy its test of probable cause.³ Certiorari was granted.⁴ HELD: The Internal Revenue Service need make no showing of probable cause to suspect fraud for enforcement of an administrative summons unless the taxpayer raises a substantial question that a judicial enforcement of the summons would be an abusive use of the court's process, predicated upon more than the fact of re-examination and the running of the statute of limitations on ordinary tax liability.

The general authority of the Internal Revenue Service to audit a taxpayer's return arises from Section 7602 of the Internal Revenue Code.⁵ Under that provision, the "Secretary or his delegate" can "examine any books, papers, records, or other data"⁶ or "summons the person . . . to produce" the same, and "to give such testimony . . . as may be relevant or material" to an authorized inquiry.⁷ Such inquiry may be for the purpose of (1) "ascertaining the correctness of any return," (2) "making a return where none has been made," (3) "determining the liability of any person for any internal revenue tax," or (4) "collecting any such liability."⁸ Two

¹ 379 U.S. 48 (1964).

² *United States v. Powell*, 325 F.2d 914 (3d Cir. 1963).

³ *Ibid.*

⁴ *United States v. Powell*, 377 U.S. 929 (1964).

⁵ Int. Rev. Code of 1954, § 7602.

⁶ Int. Rev. Code of 1954, § 7602(1).

⁷ Int. Rev. Code of 1954, § 7602(2).

⁸ Int. Rev. Code of 1954, § 7602. Under section 7604(a), the United States district courts have jurisdiction to enforce a summons issued pursuant to section 7602(2). Section 7604(b) gives the district courts the power to hold for contempt any person who contumaciously refused to obey such summons. *Reisman v. Caplin*, 375 U.S. 440, 448 (1964).

limitations, however, have been imposed upon this investigative power. First, section 6501(a) limits the time within which the amount of any ordinary tax liability may be assessed to three years.⁹ If a tax cannot be assessed, it logically follows that an investigation from which the assessment would result, cannot be conducted. In the case of fraud, however, time in no way bars investigation. Under section 6501(c), a "tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time."¹⁰ Secondly, section 7605(b)¹¹ imposes two further restrictions upon the power granted by section 7602.¹² The first clause of this section is prohibitive in nature; it forbids the commencement of any *unnecessary* examination or investigation of a taxpayer. This is so whether the books of the taxpayer or of a third person are summoned.¹³ The second clause, on the other hand, is more restrictive. It allows only one inspection of a *taxpayer's books of account* for each taxable year unless the Regional Commissioner, "after investigation, notifies the taxpayer in writing that an additional inspection is necessary."¹⁴

In the instant case, the Court rejected any interpretation of these sections that might place upon the Service the burden of demonstrating necessity before a second examination would be allowed.¹⁵ Specifically, the Court rejected taxpayer's argument that section 7605 required the government to "establish probable cause to suspect fraud."¹⁶ It reasoned that necessity was not to be equated with probable cause even though the statute of limitations on ordinary tax liability had run.¹⁷ When a fraud has been perpetrated, there exists at all times a tax liability, which the Commissioner is authorized to investigate under section 7602. While conducting this examination, the Commissioner could demand taxpayer's records if, "in order to determine the existence or nonexistence of fraud in the taxpayer's returns, information in the taxpayer's records is needed which is not already in the Commissioner's possession."¹⁸ As a result, the Court in regard to *Powell* concluded that "the examination is not 'unnecessary' within the meaning of Section 7605(b)."¹⁹ To require a probable cause showing might seriously hamper the government in carrying out warranted investigations. The Commissioner would have to

⁹ Int. Rev. Code of 1954, § 6501(a).

¹⁰ Int. Rev. Code of 1954, § 6501(c)(1), (2). Two other exceptions to the three year statute of limitations are included in section 6501(c). Under section 6501(c)(3) a tax may be assessed at any time if the taxpayer has failed to file a tax return and under section 6501(c)(4), the period of limitation can be extended by agreement. Furthermore, section 6501(e) extends the statute of limitations to six years "if the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return. . . ."

¹¹ Int. Rev. Code of 1954, § 7605(b).

¹² See *DeMasters v. Arend*, 313 F.2d 79, 85-86 (9th Cir. 1963).

¹³ *Id.* at 86.

¹⁴ Int. Rev. Code of 1954, § 7605(b); see *DeMasters v. Arend*, *supra* note 12.

¹⁵ *United States v. Powell*, *supra* note 1, at 51, 53-56.

¹⁶ *Id.* at 51.

¹⁷ *Id.* at 53-54.

¹⁸ *Id.* at 53.

¹⁹ *Ibid.*

prove the reasonableness of his belief prior to the examination of the only records which provide the ultimate truth.²⁰

Secondly, the Court grounded its interpretation of section 7605(b) on legislative history.²¹ Reports of the congressional hearings do not intimate "that Congress intended the courts to oversee the Commissioner's determinations to investigate. No mention was made of the statute of limitations and the exception for fraud."²² Section 7605(b) was enacted to protect the taxpayer from repetitive and unnecessary examinations.²³ However, the Court found a "probable cause" interpretation unacceptable "without some solid indication in the legislative history that such a gloss was intended."²⁴

Prior to this decision, judicial opinion had differed with respect to the scope of the Service's investigative power.²⁵ The First and the Third Circuits, in cases such as this, had interpreted the applicable sections of the Internal Revenue Code as requiring the Commissioner to establish to the satisfaction of the enforcing court that there was probable cause or a reasonable basis for belief that the taxpayer had perpetrated a fraud.²⁶ They reasoned that before the closing of the period of limitations, efficient and prompt enforcement of the tax laws demanded that no stringent burden be placed upon the Service.²⁷ However, after the running of the statute of limitations on ordinary tax liability, the equities were said to be reversed, and the interests of the taxpayer were held to be paramount.²⁸ Any previous tax year became a "closed year," reviewable only for fraud.²⁹ If the taxpayer must "reach far back into the past" to produce records which may have been lost or destroyed or about which memories may have faded, his protection demanded that the Commissioner establish the necessity of the examination by showing a reasonable basis for his suspicion of fraud.³⁰ Furthermore, it was believed that this burden would not seriously hamper the government in conducting warranted examinations. As was stated by the Court of Appeals for the First Circuit in *O'Connor v. O'Connell*:

This does not mean that proof of fraud is required. It means only that before the tax authorities are entitled to a district court order enforcing a summons directing a taxpayer to testify as to a closed

²⁰ Id. at 54.

²¹ Id. at 54-56.

²² Id. at 56.

²³ Ibid.

²⁴ Ibid. The Court gave a third reason for its interpretation of section 7605(b). "This view of the statute is reinforced by the general rejection of probable cause requirements in like circumstances involving other agencies." Id. at 57.

²⁵ See *DeMasters v. Arend*, supra note 12, at 88 n.28; *McDermott v. John Baumgarth Co.*, 286 F.2d 864, 866 (7th Cir. 1961); *O'Connor v. O'Connell*, 253 F.2d 365, 369 (1st Cir. 1958).

²⁶ *United States v. Powell*, supra note 2; *Lash v. Nighosian*, 273 F.2d 185 (1st Cir. 1960); *O'Connor v. O'Connell*, supra note 25.

²⁷ See *O'Connor v. O'Connell*, supra note 25, at 369, noted in 10 *Hastings L.J.* 211 (1958).

²⁸ Ibid.

²⁹ *United States v. Powell*, supra note 2; *O'Connor v. O'Connell*, supra note 25. See *Lash v. Nighosian*, supra note 26.

³⁰ *O'Connor v. O'Connell*, supra note 25, at 370.

year they must establish to the district court's satisfaction that a reasonable basis exists for a *suspicion of fraud*, or put another way, that there is probable cause to *believe* that the taxpayer was guilty of fraud in a statute barred year. (Emphasis added.)³¹

The majority of the circuits, however, did not require a probable cause showing for a re-examination after the statute of limitations had run on ordinary tax liability.³² While the standards adopted by the respective courts of these circuits may have varied,³³ the rationale adopted by all was the same as that employed by the *Powell* Court.³⁴

A logical reading of the applicable sections of the Internal Revenue Code calls for the decision handed down. Under section 7602, the Service is permitted to re-examine the taxpayer's returns for the purpose of (1) ascertaining the correctness of the returns and (2) determining the liability of the taxpayer for any internal revenue tax. An examination for the purpose of determining fraud falls within both of these jurisdictional requirements. Section 6501(a), moreover, places no further restriction upon the Service. While an assessment for an ordinary tax deficiency is precluded, a penalty upon the finding of fraud is not. Section 6501(c) explicitly provides that a prosecution for fraud is never barred. Finally, section 7605(b) imposes no restriction upon the authority granted to the Service by sections 7602 and 6501. It is submitted that the Court was correct when it described section 7605(b) as forbidding merely the unauthorized investigation by low-echelon revenue agents and commanding only the exercise of prudent judgment by all agents "in wielding the extensive powers granted to them by the Internal Revenue Code."³⁵ The only purpose for this section is to protect the taxpayer against "unnecessary" and repetitive examinations.³⁶ There appears to be no intima-

³¹ *Ibid.*

³² See *United States v. Ryan*, 320 F.2d 500 (6th Cir. 1963), *aff'd*, 379 U.S. 61 (1964); *Foster v. United States*, 265 F.2d 183 (2d Cir. 1959); *Globe Constr. Co. v. Humphrey*, 229 F.2d 148 (5th Cir. 1956); *United States v. United Distillers Prods. Corp.*, 156 F.2d 872 (2d Cir. 1946). But see *Application of Magnus*, 299 F.2d 335, 337 (2d Cir. 1962), where the court, while holding that a taxpayer had no standing to institute an action to quash a summons compelling a third party to produce records, stated "as to taxpayers, nothing said so far prevents them from enjoying the benefits of the section [Section 7605]."

A third group of cases came out of the Fourth and Seventh Circuits. While declining to fix a standard, these circuits affirmed decisions of district courts enforcing administrative summons on the grounds that a probable cause had been shown. *Wall v. Mitchell*, 287 F.2d 31 (4th Cir. 1961); *McDermott v. John Baumgarth Co.*, *supra* note 25.

³³ See, *DeMasters v. Arend*, *supra* note 12 (investigation not "unnecessary" if the decision to investigate was in fact reached as a matter of rational judgment). *Foster v. United States*, *supra* note 32 (enforcement ordered if the examination "may shed light on whether a liability still exists or whether it has been time-barred"); *Globe Constr. Co. v. Humphrey*, *supra* note 32 (no showing at all required).

³⁴ Compare *DeMasters v. Arend*, *supra* note 12, with *United States v. Powell*, *supra* note 1.

³⁵ *United States v. Powell*, *supra* note 1, at 56.

³⁶ See 61 Cong. Rec. 5855 (1921) (remarks of Senator Penrose); 61 Cong. Rec. 5202 (1921) (remarks of Congressman Hawley); 67 Cong. Rec. 3856 (1926) (a substantial measure to meet the problem in the instant case was rejected).

tion in the Code or legislative history³⁷ that Congress intended to impose a probable cause standard upon the Commissioner as a prerequisite to his re-examination of the taxpayer's books of account after the statute of limitations had run on an ordinary tax liability. As noted above, this was only the interpretation given to section 7605(b) by certain of the circuits when confronted with a problem identical to that presented by the *Powell* case.³⁸

The second factor that supports this decision can be found in an examination of the prevailing view concerning the scope of the investigatory powers of the other administrative agencies.

During the formative years of the governmental agencies, the Fourth Amendment guarantee against unreasonable searches and seizures imposed substantial restrictions upon all the agencies.³⁹ Not only had the administrator the burden of showing that the records summoned were relevant and material to the purpose for which they were sought, but he also had the burden of establishing that there was probable cause for the investigation.⁴⁰ By 1946, however, this limitation had been eliminated.⁴¹ In that year, the Supreme Court, in *Oklahoma Press Publishing Co. v. Walling*,⁴² while sustaining the constitutionality of the investigative power under Sections 9 and 11 of the Fair Labor Standards Act, held:

The requirement of "probable cause" . . . is satisfied . . . by the court's determination that the investigation is authorized by Congress, is for a purpose Congress can order, and the documents sought are relevant to the inquiry. . . .⁴³

Complete freedom was granted to the agencies in 1950 when the Court in *United States v. Morton Salt Co.*,⁴⁴ speaking of the Federal Trade Commission, stated:

It has a power of inquisition, if one chooses to call it that, which is not derived from the judicial function. It is more analogous to the Grand Jury, which does not depend on a case or controversy for power to get evidence but can investigate *merely on suspicion that the law is being violated, or even just because it wants assurance that it is not.* (Emphasis added.)⁴⁵

Presently, "not a single important regulatory statute fails to provide broad

³⁷ Ibid.

³⁸ Cases cited note 26, *supra*.

³⁹ Note, Resisting Enforcement of Administrative Subpoenas Duces Tecum: Another Look at *CAB v. Hermann*, 69 Yale L.J. 131, 132 (1959).

⁴⁰ *Hale v. Henkel*, 201 U.S. 43, 76 (1906); *In re Andrews' Tax Liability*, 18 F. Supp. 804 (D. Md. 1937). See Note, Resisting Enforcement of Administrative Subpoenas Duces Tecum, *supra* note 39; 1 Davis, *Administrative Law Treatise* § 3.12 (1958).

⁴¹ See *Fleming v. Montgomery Ward & Co.*, 114 F.2d 384 (7th Cir. 1940).

⁴² 327 U.S. 186 (1946).

⁴³ Id. at 209. 60 Stat. 1095 (1946), 29 U.S.C. § 209 (1958); 63 Stat. 916 (1949), 29 U.S.C. § 211 (1958).

⁴⁴ 338 U.S. 632 (1950). See *Administrative Procedure Act* § 6(c), 60 Stat. 240 (1946), 5 U.S.C. § 1005(c) (1952).

⁴⁵ *United States v. Morton Salt Co.*, *supra* note 44, at 642-43.

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powers . . . to compel production of evidence."⁴⁶ For example, the Antitrust Civil Process Act enacted in 1962 gives the Attorney General the authority to "issue in writing, and cause to be served upon . . . [a person] a civil investigative demand requiring such person to produce such material for examination."⁴⁷ Provision is also made for judicial enforcement of a summons issued under this act.⁴⁸ It appears, moreover, that all the Attorney General must show is that the inquiry is one the Antitrust Division is authorized by law to make, that the materials summoned are relevant to the authorized inquiry, and that the disclosure sought is reasonable.⁴⁹ Current judicial construction, moreover, is not lacking. In 1962, the Court of Appeals for the Sixth Circuit, in *Goldberg v. Drivers Local Union No. 299*, held that the Secretary of Labor, pursuant to the National Labor Relations Act, did not have to make a showing of probable cause to enforce a subpoena.⁵⁰

By its decision in the *Powell* case, the Court has accepted this prevailing view and has aligned the Internal Revenue Service with the other federal agencies. It read the Internal Revenue Code as imposing no standard of probable cause upon the Commissioner to obtain enforcement of his summons in fraud cases, either before or after the three year statute of limitations on ordinary tax liabilities has expired.⁵¹ It also imposed upon the Service the same burden as was placed upon other agencies in the *Oklahoma Press* case. The Commissioner must show that the investigation will be conducted pursuant to a statutory purpose, that the administrative steps required by the Code have been followed, and that the inquiry may be relevant to that purpose.⁵²

The Court, however, did not leave the taxpayer defenseless, but provided a means by which he can force the court to inquire "into the underlying reasons for the examination."⁵³ A few months prior to the *Powell* case, the Court, in *Reisman v. Caplin*,⁵⁴ decided for the first time that the taxpayer could "challenge the summons on any appropriate ground."⁵⁵ All that the Court demanded was that any action to enforce a summons issued under section 7602 must be commenced in a district court or before a United States Commissioner providing the taxpayer a judicial determination of any challenge to

⁴⁶ 1 Davis, Administrative Law Treatise § 3.03 (1958).

⁴⁷ Antitrust Civil Process Act, 76 Stat. 548, 15 U.S.C. § 1312(a) (Supp. V, 1964).

⁴⁸ 76 Stat. 551, 15 U.S.C. § 1314 (Supp. V, 1964).

⁴⁹ 76 Stat. 548, 15 U.S.C. § 1312 (Supp. V, 1964):

(b) Each such demand shall—

(1) state the nature of the conduct constituting the alleged antitrust violation which is under investigation and the provision of law applicable thereto;

(2) describe the class or classes of documentary material to be produced thereunder

(c) No such demand shall—

(1) contain any requirement which would be held to be unreasonable

⁵⁰ 293 F.2d 807 (6th Cir. 1961).

⁵¹ *United States v. Powell*, supra note 1, at 56.

⁵² *Id.* at 57-58. See also Int. Rev. Code of 1954, § 7602.

⁵³ *Id.* at 58.

⁵⁴ 375 U.S. 440 (1964).

⁵⁵ *Id.* at 449.

the summons.⁵⁶ It is submitted that this Court has accepted and expanded this holding. Under *Powell*, a proceeding to enforce the Commissioner's summons must be instituted pursuant to the Federal Rules of Civil Procedure by filing a complaint followed by answer and hearing.⁵⁷ At this time, if the taxpayer raises a substantial question that an enforcement of the summons would be an abusive use of the court's process, then according to the Court's holding, the government will have to make a showing of probable cause.⁵⁸ The taxpayer can meet the burden by showing that the summons had been issued to "harass the taxpayer or to put pressure on him to settle a collateral dispute, or for any other purpose reflecting on the good faith of the particular investigation."⁵⁹

ROBERT J. DESIDERIO

Antitrust—Sherman Act—Inducing State Officer To Enforce a Law—*Harman v. Valley Nat'l Bank*.¹—Appellant, trustee of the Coffeyville Loan and Investment Co., brought an action under Section 4 of the Clayton Act,² alleging violation of Sections 1 and 2 of the Sherman Act.³ Appellant averred that the defendants had conspired, together with the Attorney General of Arizona, fraudulently to place the Arizona Savings and Loan Association in receivership under Arizona law,⁴ as part of a scheme to restrain and monopolize financial transactions in the area. The state receiver refused to honor the appellant's contracts with Arizona Savings, thus limiting its refinancing resources. The district court held that appellant failed to state a cause of action upon which relief could be granted and dismissed the action. Reversing, the Ninth Circuit HELD: Merely inducing a state officer to enforce a law, regardless of the substantive merits of the enforcement, is not prohibited by the antitrust laws; allegations of this enforcement, however, either as part of a larger anti-competitive scheme or one in which the state officer was a conspirator are sufficient to state a cause of action.

Although the Sherman Act prohibits "every" agreement designed to monopolize trade, the Supreme Court has held that it applies only to "unreasonable" restraints on trade.⁵ In determining unreasonableness the Court

⁵⁶ *Id.* at 445-46.

⁵⁷ *United States v. Powell*, *supra* note 1, at 58 n.18.

⁵⁸ *Id.* at 51: "We reverse, and hold that the Government need make no showing of probable cause to suspect fraud *unless* the taxpayer raises a substantial question" (Emphasis added.)

⁵⁹ *Id.* at 58.

¹ 339 F.2d 564 (9th Cir. 1964).

² "Any person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws may sue. . . ." 38 Stat. 731 (1914), 15 U.S.C. § 15 (1958).

³ "Every contract, combination . . . or conspiracy, in restraint of trade or commerce . . . is declared to be illegal. . . . Every person who shall monopolize, or attempt to monopolize . . . any part of [interstate or foreign] trade . . . shall be deemed guilty of a misdemeanor. . . ." 26 Stat. 209 (1890), as amended, 15 U.S.C. §§ 1, 2 (1958).

⁴ *Ariz. Rev. Stat. Ann.* §§ 6-422, 423 (1956), as amended, *Ariz. Rev. Stat. Ann.* §§ 6-480, 481 (Supp. 1964).

⁵ *Standard Oil Co. v. United States*, 221 U.S. 1 (1910).